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TESTIMONY OF DEBORAH R. BORTNER

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Before the

**Senate Governmental Affairs Committee
Permanent Subcommittee on Investigations**

Hearing on Day Trading

February 25, 2000

Chairman Collins, Senator Levin and Members of the Subcommittee:

I am Deborah Bortner, Director of Securities for the State of Washington and president-elect of the North American Securities Administrators Association (NASAA).¹ I want to thank you for the opportunity to appear before you as you continue to look into issues associated with the day trading industry.

NASAA's Concern with Day Trading

As you know, Chairman Collins, day trading has been a concern of state securities regulators for several years now. In 1998, the Colorado Securities Commissioner raised concerns about day trading firms in his state and imposed restrictions on their operations. Massachusetts, Wisconsin and Texas also brought numerous enforcement actions after examining firms in their states. By sounding the alarm on questionable day trading practices, other states were alerted to the presence of these firms in their states and clients were also put on notice of regulators' concerns.

The states realized that the national scope of this problem required the assistance of their federal regulatory counterparts and we appreciate your leadership in bringing this issue to the attention of Congress.

Because of ongoing concerns, in December 1998, the NASAA Board of Directors formed a Day Trading Project Group to conduct research about the industry, prepare a report of its findings and make recommendations. The Project Group was also mandated to assist state securities agencies in confronting this issue by first providing them information to assist their enforcement efforts and secondly by educating the citizens of their states on the risks inherent in this type of investing.

The Project Group worked for seven months gathering information, analyzing issues and studying trading records with the assistance of a consultant. The result of that effort was the "NASAA Day Trading Project Group Report," dated August 9, 1999. NASAA President Peter Hildreth testified before this subcommittee on the specifics of the report last September and a copy of the report and appendix was submitted into the record. It is available on the NASAA web site at www.nasaa.org.

The NASAA report, the first of its kind, catalogued problems regulators found in the day trading industry, including misleading marketing, lax supervision and questionable loan schemes. The Report did not suggest major restrictions or a ban on day trading per se, but called on the firms to do a better job of screening potential customers and disclosing the substantial risks of day trading.

¹ The oldest international organization devoted to investor protection, the North American Securities Administrators Association, Inc., was organized in 1919. Its membership consists of the securities administrators in the 50 states, the District of Columbia, Canada, Mexico and Puerto Rico. NASAA is the voice of securities agencies responsible for grass-roots investor protection and efficient capital formation.

Regulatory Actions

Last fall, NASAA commented on the rules proposed by the National Association of Securities Dealers Regulation (NASDR) relating to the opening of day trading accounts.² The proposed rule change would require a member firm that is promoting a day trading strategy to furnish a risk disclosure statement to a non-institutional customer prior to opening an account for the customer and to either (1) approve the customer's account for a day trading strategy or (2) obtain from the customer a written agreement that the customer does not intend to use the account for day trading purposes.

NASAA supports the proposed rules which explicitly specify the industry's obligations and recommends that the member firm be required to obtain the customer's signature on the disclosure statement so that it would become part of the member firm's books and records.

This is an important point to emphasize. Currently, the NASD and the SEC require affirmative disclosure to customers prior to engaging in risky activities such as "margin borrowing," "options trading" and purchasing "penny stocks." The brokerage firm is obligated to provide the client with a disclosure statement that details the risk involved in engaging in such activity, the client must sign this disclosure and then it becomes part of the firm's permanent books and records and available for regulatory inspection.

Washington State Report

I am here today not to go over the findings of the NASAA report or to comment on day trading in general, but to focus on a Washington State Report based on recent field examinations of all day trading firms believed to have branches in our State. These exams were undertaken in order to determine whether the branches in the State of Washington would evidence the same kind of problems identified in various state actions around the U.S.

The examination team was assigned the responsibility of inspecting the activities of day trading firms for misleading advertising, questionable loans or guarantees, third-party trading and unsuitable trading accounts. The team was also given the task of looking into possible unregistered broker-dealer and investment adviser activities and short sale violations.

The examination team limited its focus to firms promoting day trading strategies³ and that offer Level II⁴ trading to their clients. Through our registration and examination records we determined there were seven day trading firms with branches located in the State of Washington. All of the firms examined were located in or near the Seattle metropolitan

² Letter from NASAA President Bradley W. Skolnik to Jonathan G. Katz dated October 12, 1999.

³ "Day trading" means buying and selling the same security on the same day. NASD Rule 2520.

⁴ Level II Trading shows the customer every market maker and individual selling a particular security and the price they are willing to pay to buy or sell it.

area. The firms were divided among three members of the examination team with a Securities Division enforcement attorney assigned to oversee the legal aspects of the assignment. The examinations were conducted during the months of September, October and November 1999.

Of the seven day trading firms inspected by the examination team, two firms accounted for more than 80% of the 585 day trading accounts serviced by the firms. The likely reason for their dominance is that they have been in the community longer than the other day trading firms.

The firms have different ways in which they operate. Four of the seven firms cater to customers who are considered to be day traders by definition (that is investors who sell what they bought for the day regardless of whether they have profited from their activity). The other three firms also appeal to day traders but commonly allow customers to hold overnight positions in securities, a practice that is considered higher risk since day traders are generally highly margined.

Three of the firms provide their customers with the opportunity to trade “off-site,” through terminals at their home, office or at a trading room at a location supervised by the firm. One firm provided only “off-site” trading. The remaining three firms only allow customers to trade at the firm’s trading room. Over 60% of the accounts reviewed took advantage of “off-site” trading. There was no discernible difference between the level of trading activity for “off-site” customers as compared to those in a trading room.

Profitability of Day Trading Accounts

Monthly statements for 124 open and active day trading accounts were reviewed and analyzed as part of the examination process. The Washington State Report shows the net profits and losses for the accounts, the time period the accounts were open and the beginning balances for the accounts.

Seventy seven percent of the accounts examined were found to have net losses with an average net loss of \$36,043⁵. Nine of the accounts had losses of over \$100,000 with one losing \$641,000.

Twenty three percent of the accounts examined were calculated to have net profits. Only two accounts had gains of over \$100,000 with an average net profit found to be \$21,983⁶. The highest profit discovered was \$160,100.

The accounts reviewed were open from one month to 25 months. The length of time an account was open and active did not appear to have a correlation with the success of the account.

⁵ This average is neither time nor dollar weighted.

⁶ Id.

Questionable Activity

Loans to Customers - Activity involving loans to customers was examined at each firm. The most common questionable lending practice identified was the facilitation of loans between customers by several firms. The firm's books and records included loan authorization forms that appeared to be pre-signed photocopies. This may indicate that the firms were assisting the customers in finding the lender. Funds being journaled between accounts within the firms raises questions regarding proper internal controls, whether authorization was received prior to the funds being transferred and whether customers were receiving adequate information on terms of the loans. We believe such loan arrangements may exist to circumvent margin loan requirements and in some cases may have exacerbated customer losses.

One firm facilitated loans to its customers on a regular basis through a company solely owned by the firm's principal. The purpose of using the separate company appears to be an effort to avoid compliance with Regulation T and margin maintenance requirements. Regulation T is a Federal Reserve Board rule that establishes the initial margin requirements governing the extension of credit to customers (presently 50%) for new purchases and short sales. NASD Rule 2520 and NYSE Rule 431 govern margin maintenance and often the firms set higher rates than the rules require.

Unregistered Investment Advisory Activity – Discretionary trading forms were found that allow the day trader to trade on behalf of third parties. This may constitute a violation of the registration provisions of the investment adviser law. These accounts have been referred to Enforcement for further investigation.

Suitability – Each of the firms purported to require a minimum balance to open and continue to operate an account. In some instances, the branch manager or the compliance officer approved new accounts with opening balances substantially under the minimum or allowed customers to continue to trade after they had fallen below the minimum. These practices raise the question as to whether the firms are in violation of the suitability review requirements of NASD Rule 3010 and NASD Rule 2310.

Other Findings

Advertising – The firms ran few advertisements from the branch offices during the examination period and two of the firms engaged in no advertising at all. Recently, questionable advertising appeared on the web site of one of the firms examined, touting the success of a principal of the firm without providing a disclaimer. This is an apparent violation of SEC Rule 270.34b-1 and NASD Rule 2210. The advertisement has been referred to Enforcement for further action.

Short Sales – Rules promulgated by the Securities and Exchange Commission and the National Association of Securities Dealers prohibit making a short sale on a down tick in price. Although short sales were made, the examination team did not detect any violations of this rule.

Washington State Report Conclusions

Seven day trading firms and 124 customer accounts were analyzed during the three-month period of September, October and November 1999. More than three-quarters (77%) of the customers at these firms appear to have lost money. Lending practices facilitated by the firms may have exacerbated those customer losses. These lending practices appear to have allowed customers to obtain loans in excess of the amounts available to them under normal trading conditions.

The exams also revealed one firm was offering day trading services without being registered.

The findings of the Washington State Report are consistent with the NASAA Day Trading Project Group Report and we stand by the conclusions of that report. Timely examinations and enforcement actions by state regulators have served to shine a spotlight on the problems of the day trading industry. Industry and federal securities regulators are now involved and are addressing the problem from a national perspective.

In conclusion, day trading is a highly risky form of trading that we continue to monitor closely. The states are working with the SEC and the NASDR to address issues in this area. I appreciate the opportunity to testify and stand ready to assist you in any way possible to protect investors and the integrity of our capital markets.